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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION SIX

NEAL FEAY COMPANY,

Plaintiff and Respondent,

v.

RUSSELL V. LUGLI et al.,

Defendants and Appellants.

2d Civil No. B255943
(Super. Ct. No. 1414187)
(Santa Barbara County)

Russell V. and Susan K. Lugli (collectively "Lugli") appeal a judgment after an order confirming an arbitration award in favor of Neal Feay Company. Lugli contends the agreement upon which the award is based was entirely illegal and therefore unenforceable. We affirm.

FACTS

In 1999, Neal Feay Company owned a 687-acre working cattle ranch in Santa Barbara County which was worth about \$3 million ("Wellspring Ranch"). Neal Rasmussen is Neal Feay Company's principal and conducted negotiations on its behalf.

Lugli owned a vacation property in Cabo San Lucas, which was worth \$1.45 million ("Vista Dos Mares"), and a 68-unit apartment building in Modesto, California, which was worth \$3 million ("Cameron Villa"). Cameron Villa was encumbered by a \$1 million loan from the Department of Housing and Urban Development (HUD).

In November 1998, Lugli offered to buy Wellspring Ranch from Neal Feay Company for \$2,950,000. Rasmussen did not accept the offer. Lugli later learned that Rasmussen wished to exchange Wellspring Ranch for other real property to avoid paying tax on capital gains (Internal Revenue Code section "1031 exchange").

Lugli offered to exchange Vista Dos Mares and a "one half interest" in Cameron Villa for Wellspring Ranch. Lugli offered to "guarantee[]" Neal Feay Company's "income [from] the apartment house" with annual payments, rather than sharing profits and losses equally. Russell Lugli later testified that he did so because he did not want to give up control of Cameron Villa. The parties agreed to the exchange after a series of counteroffers in which they negotiated the amount of the guaranteed payments, among other things.

The final agreement is embodied in a real estate purchase and sale agreement that consists of multiple offers and counteroffers. Lugli guaranteed annual payments to Neal Feay Company in the amount of \$100,000 the first year, increasing incrementally to \$120,000 in the "[f]ifth year and every year thereafter." The agreement did not tie these payments to Cameron Villa's actual profits or losses. Lugli refused to make the fifth and following year payments ("120,000 or 50% of the net profit, whichever is greater"). As it turned out, Neal Feay Company got the better bargain because Cameron Villa was not very profitable in the years following the agreement.

The 1031 Exchange and Neal Feay Company's Tax Filing

After signing the real estate purchase and sale agreement in February 1999, the parties learned that Vista Dos Mares would not qualify for a 1031 exchange because it is a foreign property. In June 1999, the parties executed a written "exchange agreement," which memorialized an exchange of Wellspring Ranch for a one-half interest in Cameron Villa. The exchange agreement did not mention Vista Dos Mares or the guaranteed Cameron Villa payments: "The parties agree to exchange an undivided one-half fee simple ownership interest as a tenant in common in Cameron Villa, subject to the debt encumbrance of record and the fee simple ownership interest

in the [Wellspring] Ranch by Grant Deed" The exchange agreement stated the "value of the Ranch, for purposes of this Agreement, is \$1,500,000." It assigned the same value to the one-half interest in Cameron Villa.

In its 1999 federal tax filing, Neal Feay Company reported a like-kind exchange of Wellspring Ranch for a one-half interest in Cameron Villa, without mention of Vista Dos Mares ("form 8824"). On a line for the "FMV of like-kind property you received," it reported "\$1,500,000." On a line for the "FMV of other property received," it reported "0." Rasmussen engaged an attorney who specialized in 1031 exchanges to prepare the filing. The attorney testified that "[he was] not sure [he] knew" that Vista Dos Mares was involved in the transaction.

Rasmussen testified that he took title to the Vista Dos Mares property in the name of another company, Neola Corporation. Rasmussen acknowledged that Vista Dos Mares "was not shown on Neal Feay Company's" 1999 tax return. He said, "I put in a tax return on another corporation, but I don't have that in front of me so I couldn't . . . say exactly where [Vista Dos Mares] was . . . claimed or shown."

Rasmussen testified that Vista Dos Mares was not included in the exchange agreement because it was not part of the 1031 exchange. He agreed that Vista Dos Mares was part of the parties' agreement: "Of course, [Vista Dos Mares] was part of the deal, but aside from the 1031 portion." Rasmussen acknowledged that he received Vista Dos Mares as partial payment for the sale of Wellspring Ranch. Russell Lugli testified that the sole purpose of the exchange agreement was to assist Neal Feay Company in its scheme to evade taxes on capital gains by providing evidence of an equal like-kind exchange that did not occur.

No other tax records were presented in the arbitration and there was no evidence whether or not Rasmussen paid federal taxes on the Vista Dos Mares gain. As the arbitrator observed, "Other than Arbitrator's suspicions--even if they are characterized as reasonable ones--there is no evidence that Rasmussen did or did not . . .

pay taxes on the other half of the gain, if any he made, when he acquired [Vista Dos Mares]."

The Cameron Villa Deed and Guaranteed Payments

After the parties signed the real estate purchase and sale agreement, Lugli delivered a deed to Neal Feay Company granting it a one-half interest in Cameron Villa. But Lugli did not record the deed. Russell Lugli testified he was afraid that if he recorded the deed, HUD would call in its loan. A condition of the HUD loan is sole-entity ownership. Neal Feay Company's one-half ownership as a tenant-in-common would violate this condition.

Russell Lugli testified that the sole purpose of the deed, like the exchange agreement, was to give Rasmussen evidence of the reported exchange in case of an IRS audit. He said that the parties' actual intent was to wait a few years to create a partnership or limited liability company (LLC) that would own Cameron Villa. Once they did, Lugli would no longer make the guaranteed payments. These terms do not appear in the written agreements.

Rasmussen's "1031 attorney" testified that if Neal Feay Company had taken an LLC or partnership interest in Cameron Villa, Rasmussen would have been unable to claim a like-kind 1031 exchange, because an interest in a partnership or an LLC is personal property, not real property like Wellspring Ranch. Rasmussen testified it was his understanding "[t]here should no inkling of an agreement other than property for property . . . [n]othing out of sight or under the table."

The parties did not form a partnership or LLC to own Cameron Villa. Lugli made guaranteed payments to Neal Feay Company for 12 years, until 2011, then stopped. In 2002, Lugli transferred Cameron Villa into an LLC and encumbered it with another loan.

Petition to Compel Arbitration

In 2012, Neal Feay Company filed a petition to compel Lugli to arbitrate. It claimed that Lugli breached the parties' agreements by failing to make guaranteed

payments after 2011, by failing to convey to Neal Feay Company a one-half interest in Cameron Villa, and by diluting Neal Feay Company's interest when it transferred Cameron Villa to an LLC and encumbered it further. As evidence of the parties' agreements, Neal Feay Company relied on the real estate purchase and sale agreement and the exchange agreement. It sought arbitration under a provision of the exchange agreement that requires arbitration of "disputes relating to this agreement." The real estate purchase and sale agreement also contains an arbitration provision.

Lugli resisted arbitration on the ground that there was no agreement to arbitrate because the exchange agreement was a "sham document created solely for [Neal Feay Company's] purpose to evidence the 1031 exchange." Lugli also argued that the claims were beyond the scope of the exchange agreement, so they did not fall within its arbitration provision. The trial court ordered the parties to arbitrate.

The Arbitration

In defense of Neal Feay Company's claims at arbitration, Lugli argued that the parties' agreement was illegal and therefore unenforceable. The arbitrator conducted an evidentiary hearing and found that the agreement was enforceable.

The arbitrator awarded Neal Feay Company one-half fee simple ownership interest in Cameron Villa, \$388,176, for unpaid guaranteed payments, and attorney fees and costs. He also decided that Lugli is obligated to continue to make \$120,000 annual payments until Lugli no longer owns or controls Cameron Villa.

The arbitrator expressed suspicions about the purpose of the exchange agreement, but found that the terms of the agreement between the parties were established in the February 1999 real estate purchase and sale agreement. The arbitrator found that the subsequent "exchange agreement did not alter the essential terms." He found that Lugli "failed to prove that a key provision of [the transaction] was to assist Rasmussen to defraud the IRS."

Confirmation of Award and Entry of Judgment

The trial court granted Neal Feay Company's motion to confirm the award and denied Lugli's motion to vacate it. The court independently reviewed the evidence in support of Lugli's claim that the transaction was entirely illegal. It concluded it was not.

The trial court found that the exchange agreement was only part of the entire transaction between the parties, and "though accomplishing a 1031 exchange may have been a motivating factor behind Neal Feay entering into the transaction, it was not the primary purpose of the entire transaction." The court found that "the terms of the entire transaction were clearly stated and understood by the parties . . . by the end of February 1999. The June 1999 Exchange Agreement was entered into as a means of effectuating the exchange portion of the agreement. The Court therefore cannot say that any intent to defraud the IRS which might have arisen was a primary purpose of the transaction between the parties"

DISCUSSION

Substantial evidence supports the trial court's determination that the transaction was not entirely illegal. Whether the transaction was partially illegal is beyond judicial review.

On appeal from an order confirming or vacating an arbitration award, we review the trial court's order de novo, but apply the substantial evidence standard to the extent the trial court's ruling rests upon its determination of disputed factual issues. (*Malek v. Blue Cross of California* (2004) 121 Cal.App.4th 44, 55-56.) We do not review the validity of the arbitrator's reasoning or the sufficiency of evidence supporting the arbitrator's award. (*Moncharsh v. Heily & Blase* (1992) 3 Cal.4th 1, 11, 28.) Arbitration awards are generally immune from judicial review. (*Id.* at p. 11.)

There is a narrow exception to the general rule of non-reviewability when a party raises a claim that the entire transaction is illegal. (*Loving & Evans v. Blick* (1949) 33 Cal.2d 603, 609.) The power of the arbitrator is dependent on the existence

of a valid contract. (*Id.* at p. 610; Code Civ.Proc., § 1286.2, subd. (a)(4).) The exception does not apply to claims of partial illegality. (*Moncharsh v. Heily & Blase, supra*, 3 Cal.4th 1, 30.)

A claim that the entire transaction is illegal must be raised before arbitration. (*Moncharsh v. Heily & Blase, supra*, 3 Cal.4th 1, 31.) Lugli did so when he resisted the petition to compel arbitration on the ground that the exchange agreement was a tax evasion sham.

Where the issue of illegality of the entire transaction is raised in a proceeding for the enforcement of the arbitrator's award, "the issue is one for judicial determination upon the evidence presented to the trial court, and any preliminary determination of legality by the arbitrator, whether in the nature of a determination of a pure question of law or a mixed question of fact and law, should not be held to be binding upon the trial court." (*Loving & Evans v. Blick, supra*, 33 Cal.2d 603, 609.) Consistent with this standard, the trial court reviewed the evidence presented to determine whether the entire transaction was illegal. Substantial evidence supports its determination that it was not.

It is essential to the existence of a contract that there be a lawful object; if there is not, the contract is unenforceable. (Civ. Code, §§ 1550, 1599, 1667.) Tax evasion is illegal. (26 U.S.C. § 7201.) The object of a contract is "the thing which it is agreed, on the part of the party receiving the consideration, to do or not to do." (Civ. Code, § 1595.) The trial court must presume lawful intent. "[I]f a contract can be performed legally, a court will presume that the parties intended a lawful mode of performance." (*Redke v. Silvertrust* (1971) 6 Cal.3d 94, 102.)

The test whether a party's claims are based on an entirely illegal transaction is "whether the plaintiff requires the aid of the illegal transaction to establish his case. If the plaintiff cannot open his case without showing that he has broken the law, the court will not assist him, whatever his claim in justice may be upon the defendant." (*C.I.T. Corp. v. Breckenridge* (1944) 63 Cal.App.2d 198, 200, quoting

Swan v. Scott (1824) 11 Serg. & Rawle 155, 164.) The most typical examples of claims based entirely on illegal transactions are actions by unlicensed professionals to collect fees for services rendered (e.g., *Loving & Evans v. Blick, supra*, 33 Cal.2d 603, 607) or actions concerning the proceeds of illegal gambling activities (e.g., *Schur v. Johnson* (1934) 2 Cal.App.2d 680, 683-684). But where the illegal transaction is collateral, the primary agreement may be enforced. For example, in *C.I.T.*, a lender could enforce a promissory note even though it funded unlicensed contract work because the lender did not need to prove the illegal transaction in order to prevail.

Proof of the claimed tax evasion Neal Feay Company engaged in was not necessary to prove its claims against Lugli. The February 1999 real estate purchase and sale agreement contained no illegal terms. It established Lugli's obligation to make annual payments and Neal Feay Company's right to a one-half interest in Cameron Villa. Its primary purpose was lawful. There is substantial evidence that Neal Feay Company's primary purpose was to acquire the Vista Dos Mares property and an interest in Cameron Villa, and Lugli's primary purpose was to acquire Wellspring Ranch. Rasmussen testified that "the benefit of the bargain was going to be \$3 million for Wellspring" and that was "going to come in a \$1.5 million interest in Cameron Villa . . . [a]nd 1.45 [million] . . . from the Cabo San Lucas property." The subsequent exchange agreement was entered into as a means of effectuating the exchange portion of the agreement, but did not change its essential terms.

This case is unlike *Homami v. Iranzadi* (1989) 211 Cal.App.3d 1104, in which a party could not enforce an oral agreement, the sole purpose of which was to circumvent income tax laws. *Homami* did not involve an arbitration award. Plaintiff sued his brother-in-law for unpaid principal on a promissory note. The note stated it would bear no interest. The brother-in-law sought a \$40,000 credit for payments he made. Plaintiff testified those were interest payments, pursuant to an oral side agreement he and his brother-in-law made "so that [plaintiff] could avoid reporting income to the Internal Revenue Service." (*Id.* at p. 1108.) Plaintiff did not prevail,

because "in order to state his claim . . . , [he] was obliged to testify and did testify that he collected interest secretly in order to circumvent income tax laws." (*Id.* at p. 1112.) Neal Feay Company was not obliged to present evidence concerning tax evasion to prove its claims against Lugli.

DISPOSITION

The judgment is affirmed. Respondent shall recover costs on appeal.

NOT TO BE PUBLISHED.

GILBERT, P. J.

We concur:

YEGAN, J.

PERREN, J.

Colleen K. Sterne, Judge
Superior Court County of Santa Barbara

Elizabeth O'Brien for Defendants and Appellants.

Arias Ozzello & Gignac LLP, J. Paul Gignac, Mischa N. Barteau, for
Plaintiff and Respondent.